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Neil Harl
Iowa State University, harl@iastate.edu

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CORPORATE LIMITATIONS ON PREPAID INPUTS

— by Neil E. Harl*

For more than four decades the Internal Revenue Service has tried to limit the amount of fertilizer, chemicals, feed, seed and other inputs that farmers could pay for and deduct in the year before the inputs are actually used or consumed.[1] Early litigation involved mostly tax shelter operations but more recent cases challenged deductions claimed by bona fide farmers.[2]

Guidance from rulings

On two occasions, IRS has issued revenue rulings which have provided guidance on deductibility of supplies purchased in the year prior to use or consumption.[3] The latest ruling, Rev. Rul. 79-229,[4] continued a three-prong test for determining whether prepayments of farm supplies are deductible. Those requirements include— (1) the transaction must involve a payment for the purchase of the input, not a mere deposit; (2) the prepayment must be for a business purpose and not merely for tax avoidance; and (3) the deduction of costs for the prepayment must not result in a material distortion of income.[5]

Farming syndicate rules

Since 1976, a "farming syndicate" has been prevented from deducting feed, seed, fertilizer and other farm supplies until used or consumed.[6] A farming syndicate is defined as (1) a partnership or other enterprise (other than a regularly-taxed corporation) engaged in farming if ownership interests have been offered for sale in an offering required to be registered with state or federal securities agencies or (2) a partnership or other enterprise (other than a regularly taxed corporation) engaged in farming if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs.[7] Even relatively inactive individual investors can be considered "limited entrepreneurs."[8]

The 50 percent limit

In 1986, Congress added another limitation which placed an upper limit on the amount of supplies that could be deducted by taxpayers on the cash method of accounting.[9] Under that limitation, amounts paid for "excess prepaid farm supplies"[10] are subject to the farming syndicate rules and, in general, are deductible no earlier than when used or consumed to the extent prepaid expenses exceed 50 percent of total deductible farming expenses excluding prepaid expenses."[11]

The key question is which taxpayers are subject to the 50 percent rule. The statute specifies that the provision applies to those who (1) are not on accrual accounting,[12] (2) have excess prepaid farm supplies for the year[13] and (3) are not a "qualified farm-related taxpayer."[14] A "qualified farm related taxpayer" may be eligible for two exceptions to the 50 percent test—the "extraordinary circumstances" exception such as from a casualty that affects business operations[15] and an exception that applies if the 50 percent test can be met over the three taxable years preceding the taxable year in question.[16]

To be eligible for the exceptions, the taxpayer must be a "farm-related taxpayer."[17] That term (farm-related taxpayer) can be met by a taxpayer— (1) whose principal residence is on a farm,[18] (2) who has a principal occupation of farming[19] or (3) who is a member of the family of a taxpayer within the bounds of the other two aspects of the definition (residence is on a farm or principal occupation is farming).[20] None of the definitions state specifically whether a corporation can be a "farm-related taxpayer" and thus be a "qualified farm-related taxpayer."[21]

A 1997 case decided by the Eleventh Circuit Court of Appeals, *Golden Rod Farms, Inc. v. United States*,[22] involved the question of whether a corporation could qualify as a "farm-related taxpayer." Golden Rod, in its 1987 fiscal year, paid over $20 million for feed and feed ingredients for its broiler chicken operations. Golden Rod deducted the entire amount even though only a portion of the feed was used during that year.

The Eleventh Circuit Court of Appeals concluded that the statute was ambiguous as to whether a corporation could be a farm-related taxpayer. However, focusing on the language in the part of the statute defining the term, the court concluded that a corporation could meet the test of "principal occupation of farming."[23] It was clear to the court that a corporation could not meet either of the other two definitions of "farm-related taxpayer." Those two definitions apply if the taxpayer's principal residence is on a farm[24] (which is not the case with a corporation) or the

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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taxpayer is a member of a family with ties to farming[25] (which certainly does not apply to a corporation).

The court's view that a corporation could have a principal occupation of farming meant that Golden Rod could be a "qualified farm-related taxpayer" and could, therefore, sidestep the rules on farming syndicates. Thus, the prepaid expenses were deductible in the year paid, 1987, rather than in the next year when used.

The decision opens up the statute and its exceptions to bona fide farm operations regardless of how organized.

FOOTNOTES

1 See generally, 4 Harl, *Agricultural Law* § 28.05[5] (1997); Harl, *Agricultural Law Manual* § 4.03[8] (1997).

2 4 Harl, *supra* n. 1, § 28.05[5] [b].

3 Rev. Rul. 79-229, 1979-2 C.B. 210; Rev. Rul. 75-152, 1975-1 C.B. 144, superseded by Rev. Rul. 79-229, 1979-2 C.B. 210.

4 1979-2 C.B. 210.

5 Rev. Rul. 79-229, 1979-2 C.B. 210.

6 I.R.C. § 464(a).

7 I.R.C. § 464(c)(1).

8 Prop. Treas. Reg. § 1.464-2(a)(1). See Estate of Wallace v. Comm'r, 95 T.C. 525 (1990), *aff'd*, 965 F.2d 1038 (11th Cir. 1992) (medical doctor who owned cattle-feeding business was limited entrepreneur who did not actively participate in cattle feeding business and profit motive was irrelevant; only feed actually consumed during year deductible).

9 I.R.C. § 464(f)(4)(A), added by Pub. L. 99-514, Sec. 404(a), 100 Stat. 2223 (1986).

10 I.R.C. § 464(f)(4)(A), (B).

11 I.R.C. § 464(f)(4)(A).

12 *Id*.

13 I.R.C. § 464(f)(2)(B).

14 I.R.C. § 464(f)(2)(C).

15 I.R.C. § 464(f)(3)(A)(ii).

16 I.R.C. § 464(f)(3)(A)(i).

17 I.R.C. § 464(f)(3)(A).

18 I.R.C. § 464(f)(3)(B)(i).

19 I.R.C. § 464(f)(3)(B)(ii).

20 I.R.C. § 464(f)(3)(B)(iii).

21 I.R.C. §§ 464(f)(3)(B), 464(f)(3)(A).

22 97-2 U.S.T.C. ¶ 50,507 (11th Cir. 1997).

23 I.R.C. § 464(f)(3)(B)(ii). See n. 19 *supra*.

24 I.R.C. § 464(f)(3)(B)(i). See n. 18 *supra*.

25 I.R.C. § 464(f)(3)(B)(iii). See n. 20 *supra*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

Chapter 11-*ALM* § 13.03.*

ELIGIBILITY. The debtor, a tomato farmer, filed a previous Chapter 11 case and had achieved a confirmed plan. The debtor, under the plan, executed a new note on a loan secured by the farm land and made a few payments to other creditors before defaulting on plan payments. The case was voluntarily dismissed by the debtor. Another creditor obtained a judgment against the debtor, the current crop of tomatoes failed, and the land mortgagee was about to foreclose when the debtor filed the current Chapter 11 case. The mortgagee argued that the new filing was not allowed because the debtor had substantially consummated the previous plan. The court held that the execution of the new note and some payments to creditors did not amount to substantial consummation of the plan. In addition, the court held that the debtor had sufficient change in circumstances after the dismissal of the first case to file the second, especially where there was no other evidence of bad faith in filing the second case. The court noted that the debtor had little chance of presenting a confirmable plan, but held that the debtor should at least have the chance to try. ***In re* Woodson, 213 B.R. 404 (Bankr. M.D. Fla. 1997)**.

Chapter 12-*ALM* § 13.03[8].*

PLAN. The debtors had purchased a cattle ranch on installments and filed for bankruptcy after defaulting on one of the annual payments. The debtors had owned the ranch for only one year so the court looked to the historical business performance of the ranch under the previous owners as well as during the time of the debtors' ownership. The debtors' plan was attacked by creditors as not feasible because the income projections exceeded the historical income from the property and the plan required negative amortization of the real property installment contract. The court reviewed the Bankruptcy Court's ruling that the plan was feasible and held that the ruling was not clearly erroneous. The court noted that, although the ranch did not have historical income to fund the plan, the debtors were experienced ranchers and had instituted several management improvements which could increase income from the ranch. The court also held that the lower court's ruling was supported by evidence that cattle prices would improve. Further, the court held that the negative amortization of the real property installment contract for two years was allowed. The court examined the plan under the ten factors enumerated in *Great Western Bank v. Sierra Woods Group, 953 F.2d 1174 (9th Cir. 1992)*. The court found that the debtors had 30 percent equity in the property, the plan was feasible, and the creditors were adequately protected during those years if the plan income did not exceed historical income. ***In re* Nauman, 213 B.R. 355 (Bankr. 9th Cir. 1997)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

CLAIM. The IRS filed a timely claim for $5,000 in 1994 corporate income taxes, and FICA and FUTA taxes. The claim included language that the claim was an estimate because of a continuing investigation. The IRS later